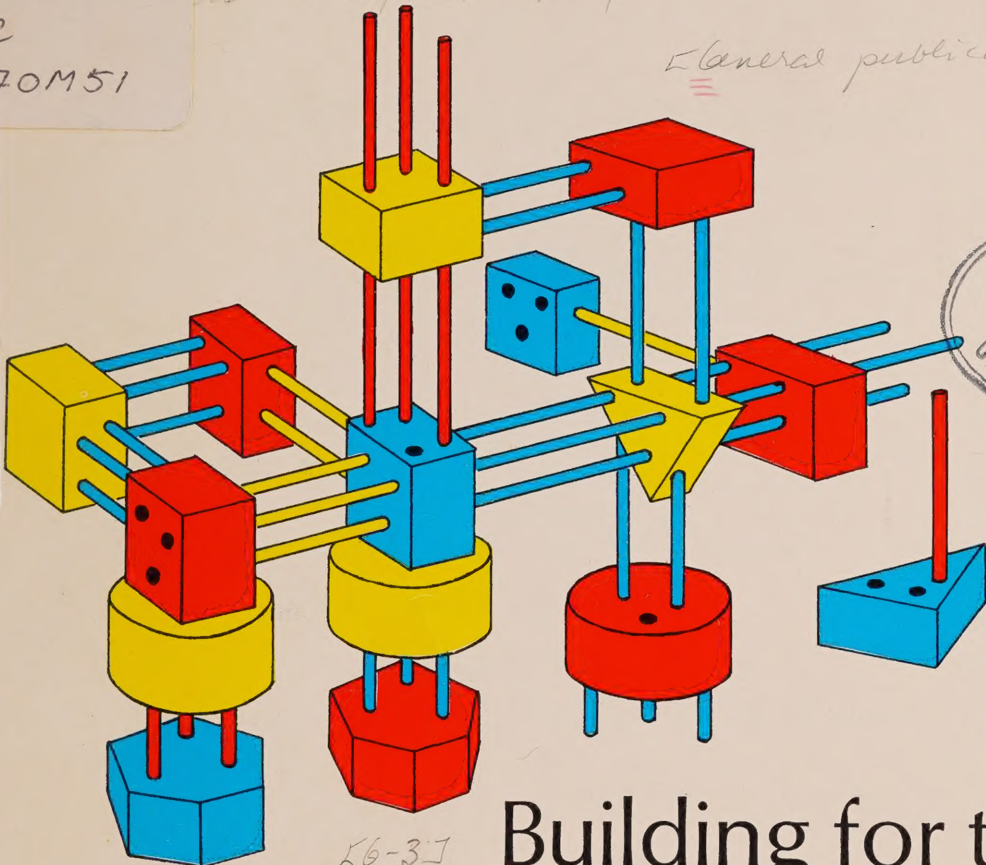
[General publication]



Motel

[6-3]

Building for the Future

Ontario Development Corporation

The Ontario Development Corporation was established in June 1966 as a successor to the Ontario Development Agency. This new Crown corporation has extended financial powers and its main functions are:

- To provide advisory, technical and management services to all types of businesses in Ontario that qualify.
- To provide financial aid to companies unable to obtain financing through the regular lending institutions, and can otherwise qualify.
- To assist in the introduction of new products or techniques.
- To assist Ontario-based companies to obtain financing from the regular lending institutions.

Minister: Hon. Stanley J. Randall

Chairman: Donald C. Early

Vice-Chairman and Managing Director: Alan Etchen

Enquiries should be addressed to: Ontario Development Corporation,
950 Yonge Street,
Toronto 5, Ontario.

Phone Area code 416
365-4622

Foreword

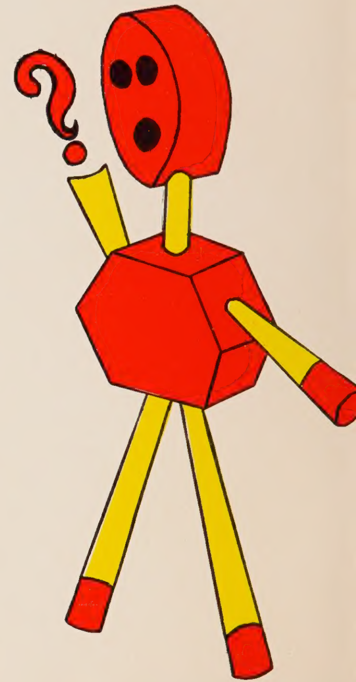
When to expand is one of the most serious questions which eventually faces many motel operators. The consequences are far-reaching, and can pose problems for even the most experienced operator.

This booklet, produced by the Ontario Development Corporation, is intended to clarify some of the major factors which should be considered in deciding for or against expansion. On the basis of the corporation's experience, it is strongly recommended that tourist operators should seek competent advice before committing themselves to expansion costs. We in the Ontario Development Corporation, along with our colleagues in the Department of Tourism and Information, are readily available to provide assistance to the tourist industry.

Hon. Stanley J. Randall

Minister of Economics and Development

Should I Expand?



The "X-Motel" is a well-managed and comfortable place to stay. Prospective guests are frequently turned away because accommodation is full — and yet net profit provides only a modest standard of living for the hard-working owner.

Why not expand then, and capture the extra business passing by?

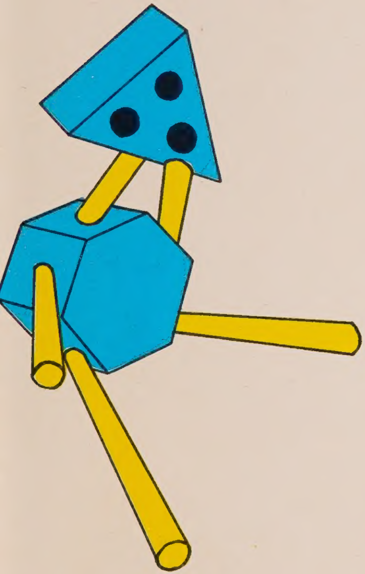
At first glance, expansion seems the logical solution to this frequent situation found in the motel industry. But in too many cases, just such an expansion is the downfall of a promising business.

Proposed expansion should be very carefully weighed before making any definite decision. Ask yourself:

- How much will expansion cost?
- Where will the money come from?
- What interest rate will I have to pay on borrowed money?
- How long will I get to repay borrowed money?
- How much gross revenue will the extra accommodation bring in?
- What extra operating expenses will I have to pay?
- What additional net profit will result?
- How will my annual cash position be affected by the expansion?
- Am I planning the right size of expansion?

Each of these questions must be carefully considered. Know the answers before committing yourself to expansion. The following will serve as a guideline:

Expansion Costs



Do not rely on guesswork. Get firm quotations for the erection of buildings. Prepare a detailed list of furniture and equipment required and price the list carefully. Be SURE of your costs.

Obtaining Finance

Few operators can finance the entire cost from their own pockets. Decide how much **you** can put in — the balance will have to be borrowed. You must satisfy prospective lenders that this is a sound investment. Support your application with financial statements of the business, and a forecast of future operations for at least one year ahead. Prove that the investment will generate a worthwhile return and that you will be able to repay the loan.

Never **assume** you will be able to borrow money. Do not put a spade into the ground until funds are **assured.**

Interest Rates

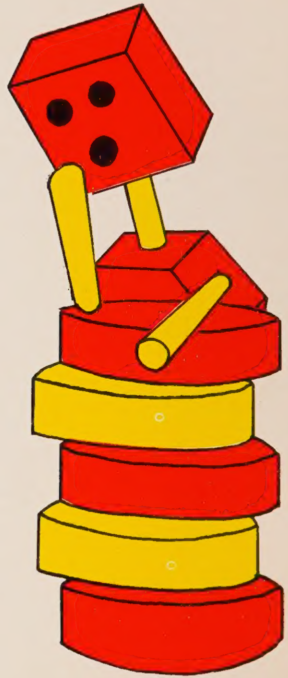
This is an important factor. Interest rates for mortgages in the tourist industry are generally high. You will probably have to pay at least 8 per cent and rates of 10 to 12 per cent are more likely.

Remember that if you borrow $40,000 at 10 per cent, interest charges in the first year will be about $4,000 — a heavy burden for any business.

Repayment Terms

Normally, the repayment period for mortgages in the tourist industry does not exceed 10 years. Frequently an even shorter period is allowed. Remember, borrowed money must be repaid within the term of the mortgage. Avoid a mortgage you are not reasonably sure you can afford to repay.

Beware of short term mortgages requiring a large final payment. You may have difficulty in making that final payment, and be unable to refinance the mortgage. Failure to meet mortgage payments may cost you your business.

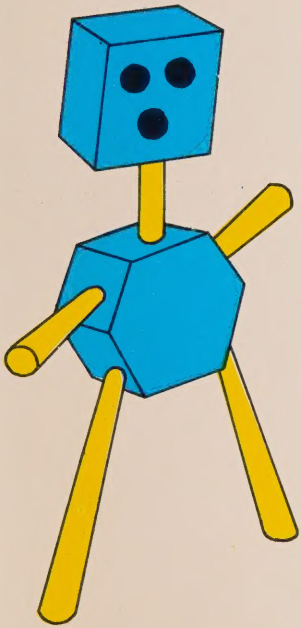


Gross Revenue

Do not guess at the gross revenue from proposed extra accommodation. You must determine how many days in the year the present accommodation is full; how many people are turned away on these days; and the average rate you could have obtained.

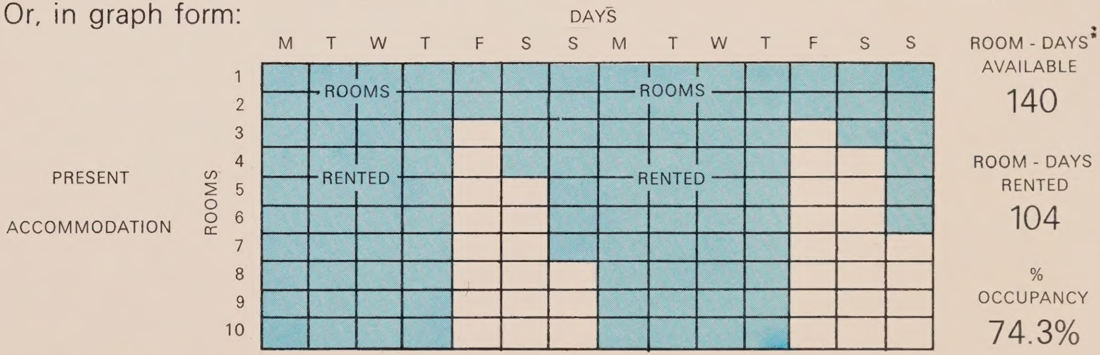
Not uncommon reasoning by many motel operators goes something like this: "I have 10 rooms and my gross revenue is $12,000 a year. I figure that if I doubled the number of rooms I could double my gross revenue". Seldom, if ever, does it work out this way. And the reason is simple: additional rooms will bring in revenue only on those days when existing accommodation is full.

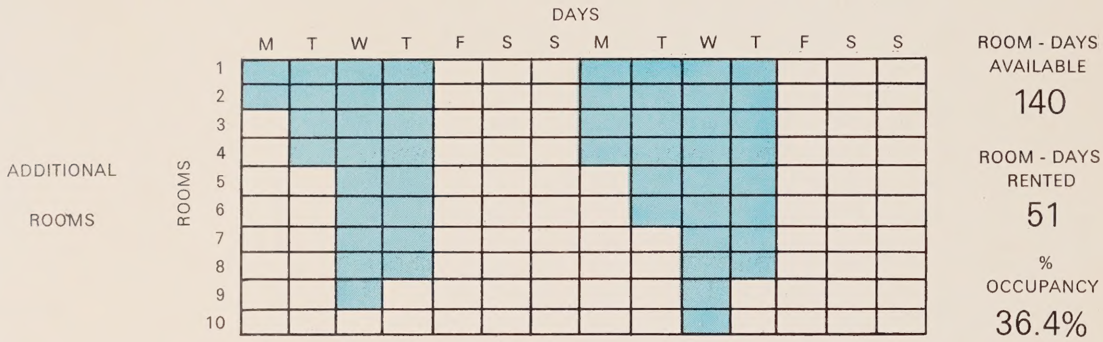
Consider the "X-Motel" again. With 10 rooms, it is located in a busy town and much of its business, year around, is commercial. In studying an average two-week period for the establishment, it will be seen that on four occasions during the two weeks, the proprietor turned away eight or more prospective guests. He planned to add 10 rooms to capture the business being turned away.

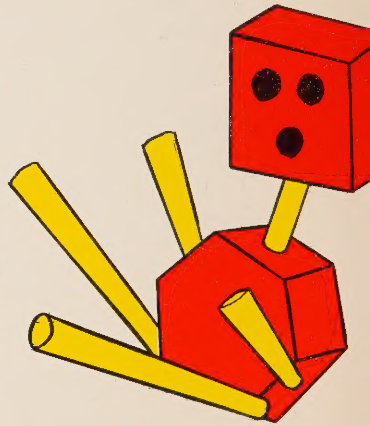


Day	M.	T.	W.	T.	F.	S.	S.	M.	T.	W.	T.	F.	S.	S.
Rooms Rented	10	10	10	10	2	4	7	10	10	10	10	2	3	6
Turned Away	2	4	9	8	—	—	—	4	6	10	8	—	—	—

Or, in graph form:





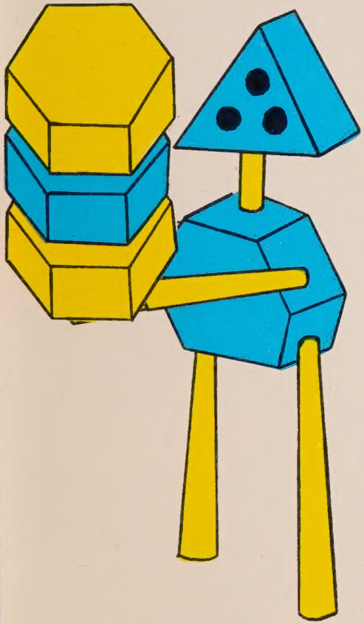


Present accommodation, then, has an occupancy rate of 74.3 per cent whereas the additional rooms would achieve an occupancy of only 36.4 per cent. Doubling the number of rooms would clearly **not** double revenue.

Extending this average two-week period to a full year, and assuming an average of $7.00 room rental per day, the revenue from the **additional** rooms would be:

Room-days available = 365 × 10 = 3,650
Room-days let — 36.4% of 3,650 = 1,328
Revenue = 1,328 × 7 = $9,300

Additional Operating Expenses



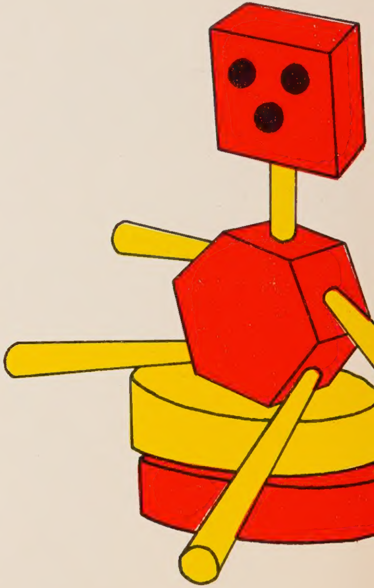
Each additional rented room involves direct expense for laundry, soap, lighting, wages, etc. In addition, some expenses will be incurred whether or not the additional rooms are rented — heat, maintenance, taxes, mortgage interest, etc.

Do not under-estimate your expenses. Study each item carefully to estimate the probable increase.

Probable expenses of the proposed "X-Motel" expansion illustrate the point. Financed by an 8 per cent mortgage for $50,000, with the principal repayable in equal quarterly instalments over 10 years, the additional expenses can be estimated:

Wages — approximately $15 weekly	$ 800
Laundry and sundries — 80c per room-day let = 1,328 × 80c	1,060
Heat, light, water	520
Maintenance	520
Taxes	100
Insurance	200
Mortgage interest	3,800
Expenses before depreciation	$7,000

Additional Net Profit



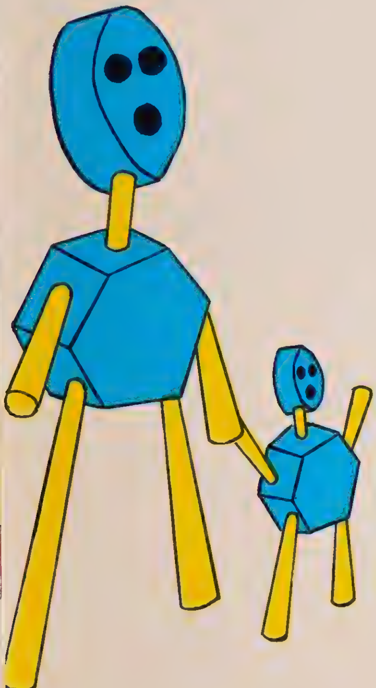
Having prepared a forecast of additional revenue and expenses, the difference will be your expected net profit from the expansion, **before depreciation.** For the "X-Motel" then, the net profit would be:

Additional revenue	$9,300
less additional expenses	7,000
Net profit, before depreciation	$2,300

Depreciation of buildings and equipment, however, is just as much a real expense as any other payment made to operate a business. If you buy a new television set for one of your rooms for instance, it may cost around $300. In one year's time it will not be worth more than, say, $240 and in five years will probably need replacing. The value of the set has been used up over the period, and must be charged against revenue to determine the real net profit.

Applying this principal to the "X-Motel" example, the real net result is quite different from the apparent $2,300 profit shown above. Assume that the $50,000 cost of expansion comprises brick buildings costing $35,000 and equipment valued at $15,000. Using the maximum capital cost allowances granted by the Income Tax Act, depreciation would be:

Buildings — 35,000 at 5%	$1,750
Equipment — 15,000 at 20%	3,000
	$4,750



The proposed "X-Motel" expansion then, would actually result in a net loss of $2,450 after charging depreciation. Obviously the expansion would be unwise unless the number of guests can be greatly increased.

Annual Cash and Expansion

As depreciation is the writing off of an asset already purchased and paid for, it is not an actual **cash** expense in the period. The cash increase resulting from operations of the expansion is therefore the net profit, **before depreciation**. For the "X-Motel", the operating cash increase from the proposed expansion is $2,300. However, requirements for principal due under mortgage and other loan agreements have to come from the cash increase. The "X-Motel's" cash position would be:

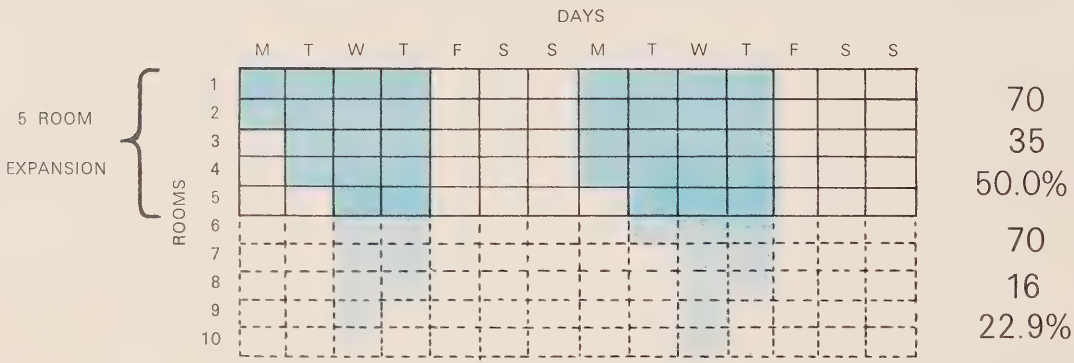
Net profit, before depreciation (cash increase)	$2,300
less repayments of mortgage principal — 1/10 of $50,000	5,000
Cash increase (decrease)	($2,700)

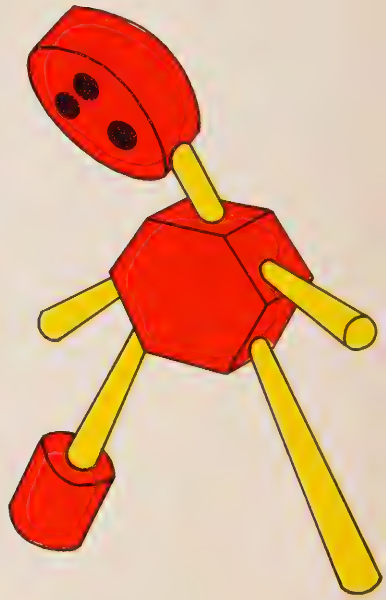
The expansion would have resulted in a net cash **decrease** of $2,700 in the first year. The proprietor needed to **improve** his annual cash position, but the proposed expansion would have the opposite effect. Probably he would have been unable to make the principal payments under the mortgage, and may have lost the entire business.

The Right Size of Expansion

The size of the expansion should also be carefully considered. It is possible you may make **more** profit if the expansion is smaller. Fixed expenses will be lower and the percentage of occupancy will be higher.

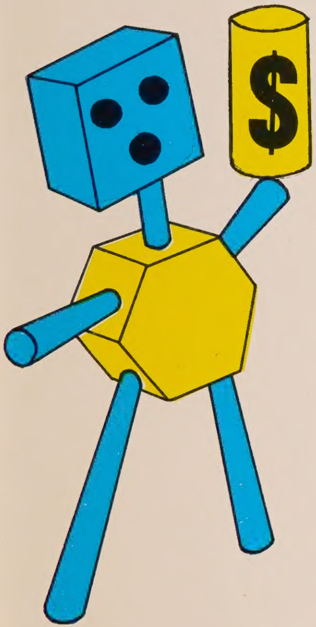
The picture would improve if the "X-Motel" expansion is smaller. Assuming that only five rooms were added at a cost of $25,000, with the same mortgage terms:





The occupancy percentage for the first five rooms is 50 per cent, but for the other five rooms it would be only 22.9 per cent. The probable revenue and expenses of the five room expansion would be:

Additional Revenue



Room - days available = 5 × 365 = 1,825		
Room - days let = 50.0% × 1,825 = 913		
REVENUE = 913 × $7 =		$6,390

Additional Expenses

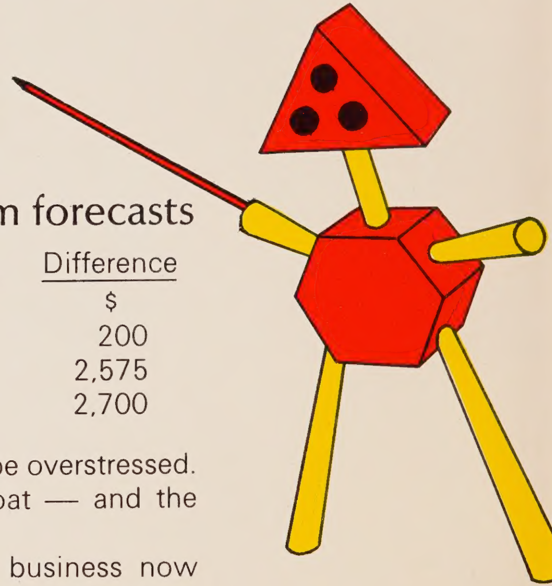
Wages — approximately $10 per week	$ 510	
Laundry and sundries = 913 × 80c	730	
Heat, light, water	300	
Maintenance	300	
Taxes	50	
Insurance	100	
Mortgage interest	1,900	3,890
Net profit before depreciation		$2,500

Depreciation

Buildings — 17,500 at 5%	875	
Equipment — 7,500 at 20%	1,500	2,375
Net profit		$ 125

Net Cash Change

Net profit, before depreciation	$2,500
less mortgage principal — 1/10 of 25,000	2,500
Cash increase (decrease)	—



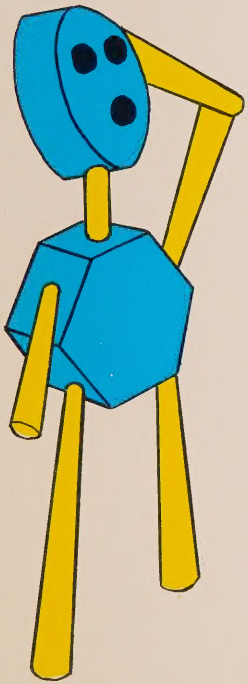
Comparison of 10 room and 5 room forecasts

	10 Room	5 Room	Difference
	$	$	$
Profit, before depreciation	2,300	2,500	200
Net profit (loss)	(2,450)	125	2,575
Net cash increase (decrease)	(2,700)	—	2,700

The importance of deciding on the right size of expansion cannot be overstressed. Adding too much to your business is as bad as overloading a boat — and the result will be the same.

It should be pointed out that the examples used reflect only business now turned away. A well planned promotion campaign may improve the occupancy and the overall results of proposed expansion.

ODC At Your Service



Plan your expansion well. Be sure of the right size, the cost and the necessary funds. Estimate your probable revenues and expenses with care and common sense. Make certain you can **comfortably** afford the mortgage and loan repayments.

When you have done all this and have satisfied yourself the expansion will be worthwhile, get the opinion of a third party. The staff of the Ontario Development Corporation will be happy to discuss facts and figures with you.

Published as a service to Ontario's motel industry
Copies ordered outside the province—$1.00
Cheques or money orders should be made payable to:
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